



Investment Thesis

Outlook

Hold-rated KKR is one of the leading alternative asset management companies with a track record of innovation, strong investment performance, and healthy fund raising (organic growth). The firm is well positioned from rising demand from alternatives and concentration of fund raising toward large GPs. However, we see KKR units trading in a range near current levels over the next 12 months for the following reasons: 1) market debate around the merits of KKR's differentiated balance sheet strategy should remain intense, but should the equity markets be choppy in 2014 vs. 2013 (as is the case so far), we think KKR units will struggle to advance as investors avoid stocks with more volatile & market-dependent earnings, and 2) KKR's distributable earnings (DE) profile through 2015 looks okay to us, and in fact could be less volatile than peers, but we also do not see a major growth catalyst in DE, thus investors may focus more on downside risks, & 3) KKR units look attractive on a sum-of-parts basis, but we see the heavier business mix toward principal income & capital markets as a weight on the P/E. Positively, KKR is executing well across each of its businesses, including generating strong organic growth, while using the balance sheet to both leverage its investing acumen and generating a higher recurring distributable earnings base (to be helped by KFN in '14)

Valuation

We believe DE, from which cash distributions are paid to unit holders, is the most important earnings metric to value the Alts, rather than economic net income (ENI) that forms Consensus estimates. Our valuation is based on assigning a target PE on our 2015 estimate for distributable earnings, a year from now. We think KKR units partially realize the benefit of the sum-of-parts debate and revalue up from 9.7x 2014E ENI to nearly 12x 2015E DE 12 months from now, narrowing its discount to the S&P 500 P/E from ~40% to ~20%. This drives a \$25 PT, near current levels, which implies a total return of 8% over the next 12 months, inclusive of a 6.5% forecast distribution yield for 2014.

Risks

Downside risks for KKR are: 1) a slowdown in US/global economy, 2) a prolonged equity market correction, & 3) failure for investors to embrace the balance sheet strategy & award KKR a higher P/E from its current discount vs. peers, and 4) substantial negative marks on the balance sheet if values of its holdings drops sharply. Additional downside risks are: loss of key personnel, a deterioration in investment performance, unfavorable regulatory legislation, a change in tax laws creating higher taxation on carried interest and/or the partnership structure, increasing competition from traditional asset managers diversifying into alternatives, and inability to broaden the investor share base if as holding partnership units can be prohibitive for some investment funds. Upside risks are 1) much stronger DE than expected if KKR leverages its investment ideas effectively in balance sheet investments and 2) investors awarding KKR a much higher PE if balance sheet risks are perceived as low.